COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION OF THE IMPACT OF	)	
FEDERAL POLICY ON NATURAL GAS	)	ADMINISTRATIVE
TO KENTUCKY CONSUMERS AND SUPPLIERS	)	CASE NO. 297

I N D E X

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In the Matter of:

AN INVESTIGATION OF THE IMPACT OF FEDERAL POLICY ON NATURAL GAS TO KENTUCKY CONSUMERS AND SUPPLIERS	)))	ADMINISTRATIVE CASE NO. 297

ORDER

PROCEDURAL BACKGROUND

The natural gas industry is undergoing fundamental change accelerated by the phased removal of wellhead price controls and the issuance of Order Nos. 351, 380, and 436 by the Federal Energy Regulatory Commission ("FERC"). The Commission issued an Order on January 17, 1986, instituting an investigation of the natural gas markets in the Commonwealth of Kentucky. This Order is intended to set forth a consistent and clear policy that will balance the interests of consumers and local distribution companies.

The Commission's Order of January 17, 1986, requested information on market share and technical aspects of the distribution network. The Order requested comments from all interested parties on questions regarding regulation, natural gas transportation, bypass, federal policy changes, acquisition practices, competition, and unbundling of rates. All natural gas utilities under the Commission's jurisdiction were made parties to the proceeding. A public hearing was conducted at the Commission's offices in Frankfort, Kentucky, on April 1, 1986, for the purpose of receiving further comments.

On September 30, 1986, the Commission issued an Order requesting comments on a Draft Order reflecting proposed positions and policy guidelines. A subsequent Order was issued on December 15, 1986, requesting testimony concerning specific questions. A public hearing was conducted at the Commission's offices in Frankfort, Kentucky, on January 7, 1987, for the purpose of receiving further comments on the Draft Order and the testimony requested in the December 15, 1986, Order.

Motions to Intervene in this proceeding were received from Alcan Aluminum ("Alcan"), Alumax Aluminum ("Alumax"), the Attorney General of the Commonwealth of Kentucky ("AG"), Entrade Corporation ("Entrade"), GTE Products ("GTE"), Kentucky Industrial Utility Customers ("KIUC"), National-Southwire Aluminum Company ("NSA"), Southern Gas Company ("Southern"), and Southwire Company ("Southwire"). These motions were granted without exception.

On January 30, 1987, a Motion to Intervene was received from Jimmy Hamilton Oil & Gas, Inc. The Commission hereby grants the motion.

Comments were received from Columbia Gas of Kentucky, Inc., ("Columbia"), Columbia Gas Transmission Corporation ("TCO"), Columbia Gulf Transmission Corporation ("Columbia Gulf"), Delta Natural Gas Company, Inc., ("Delta"), Elam Utility Company ("Elam"), Equitable Gas Company ("Equitable"), Johnson County Gas Company ("Johnson Co."), Kentucky Ohio Gas Company ("Ky-Ohio"), Kentucky Legal Services, Louisville Gas and Electric Company ("LG&E"), Midwestern Gas Transmission Corporation ("Midwestern"), Shawnee Pipeline Company ("Shawnee Pipeline"), Stand Energy Corporation ("Stand Energy"), Tennessee Gas Pipeline Company ("Tennessee"), Texas Eastern Gas Pipeline Company ("Texas Eastern"), Texas Gas Transmission Corporation ("Texas Gas"), The Union Light, Heat and Power Company ("ULH&P"), Valley Gas, Inc., ("Valley"), Western Kentucky Gas Company ("WKG"), Xebec Gas Company ("Xebec"), the AG, GTE, KIUC, and Southern.

CURRENT STATUS

The revolution of the natural gas industry in Kentucky is evident in the tariffs of certain local distribution companies ("LDCs") filed with this Commission. The five Class A distribution companies in Kentucky have rates in effect for natural gas transportation apart from natural gas sales rates. These companies are Columbia, Delta, LG&E, ULH&P, and WKG.

In 1985 the Commission approved tariffs for Columbia and ULH&P making interruptible natural gas transportation available to customers who could demonstrate access to a cheaper alternate fuel. The tariffs allow both companies the flexibility to lower the transportation rate, as necessary, to compete with alternate fuels. Transportation has been available only by special contract to customers without an alternate fuel capability.

LG&E, WKG, and Delta offer interruptible transportation for commercial and industrial customers that have secured their own natural gas supply. The tariffs of these companies do not require an alternate fuel capability for transportation service.

Generally the transportation rates are based on the gross margin; that is, they are designed to recover the costs included in gas sales rates less the cost of gas. Demand charges incurred by the LDC attributable to customers that opt for transportation may also be included in the rates.

As further explained in successive paragraphs, LDCs have designed various tariffs offering service to meet the needs of end-users. Each of these tariffs is a marketing tool developed to enable the LDC to compete with other gas sources and/or alternate fuels.

WKG offers a transportation rate of 15 cents per MCF to deliver gas from its storage. This gas must have been purchased by the customer from WKG for seasonal storage. Delta offers an off-system transportation rate of 25 cents per MCF by contract to any person who desires transportation of gas purchased from another source that has connecting facilities.

Columbia offers two types of special sales rate tariffs to meet competition from alternate fuels. Columbia's Alternate Fuel Displacement Service ("AFDS-2") is a variable pricing tariff which tracks the price of #2 fuel oil. The sales price for gas may vary between the Columbia sales rate, per the applicable rate schedule, and a floor rate equal to the commodity charge of TCO plus 10 cents. On May 2, 1986, the Commission approved as experimental Columbia's "Special Interim Agency Service" ("SIAS") tariff. It is offered on a best efforts basis (interruptible), available over a 12-month period to certain commercial and industrial customers who can demonstrate that gas purchased will replace alternate fuel. The rate is set monthly as determined by the highest cost portion of "shopping volumes" plus Columbia's transportation rate plus a 5 cent agency fee. The agency fee is credited to other customers through Columbia's Gas Cost Adjustment.

On April 18, 1986, the Commission approved on an experimental basis ULH&P's proposed "Competitive Fuel" tariff. The rate is based on ULH&P's highest cost source of spot market purchases plus the company's transportation rate plus a 5 cent agency fee. This is also a best efforts tariff similar to Columbia's SIAS tariff, with the agency fee being credited to other customers.

DEFINITIONS

To aid in understanding the Commission's responsibilities in the natural gas sector a summary of definitions follows:

Utility - Per KRS 278.010 (3) (b) (c)

> . . . .
>
> (3) "Utility" means any person except a city, who owns controls or operates or manages any facility used or to be used for or in connection with:
>
> . . . .
>
> (b) The production, manufacture, storage, distribution, sale or furnishing of natural or manufactured gas, or a mixture of same, to or for the public, for compensation, for light, heat, power or other uses;
>
> (c) The transporting or conveying of gas, crude oil or other fluid substance by pipeline to or for the public, for compensation;
>
> Per KRS 278.470
>
> Every company receiving, transporting or delivering a supply of oil or natural gas for public consumption is declared to be a common carrier, and the receipt, transportation and delivery of natural gas into, through and from a pipeline operated by any such company is declared to be a public use.

Intrastate Pipeline - Per KRS 278.504

(1) ... means any utility or any other person engaged in natural gas transportation in intrastate commerce, for compensation, to or for another person or to or for the public, but shall not include any part of any pipeline dedicated to storage or gathering or low pressure distribution of natural gas;

Interstate Pipeline - Per KRS 278.504

(2) ... means any person engaged in natural gas transportation subject to the jurisdiction of the federal energy regulatory commission under the natural gas act or the natural gas policy act of 1978;

Local Distribution Company - Per KRS 278.504

(3) ... means any utility or any other person, other than an interstate pipeline or an intrastate pipeline, engaged in transportation or local distribution of natural gas and the sale of natural gas for ultimate consumption, but shall not include any part of any pipeline primarily used for storage or gathering or low pressure distribution of natural gas;

Intrastate Commerce - Per KRS 278.504

(4) ... includes the production, gathering, treatment, processing, transportation and delivery of natural gas entirely within the Commonwealth which is not subject to the jurisdiction of the federal energy regulatory commission under the natural gas act or the natural gas policy act of 1978;

Transportation - Per KRS 278.504

(5) ... includes exchange, backhaul, displacement or other means of transportation;

Class A LDC - Per Uniform System of Accounts

A local distribution company having annual gas operating revenues of $2,500,000 or more.

Broker

A broker is a person engaged in the practice of arranging supply and transportation of natural gas for specific customers. Brokers do not take title to the gas and possess no physical plant.

Dealer

A dealer is a person engaged in the practice of purchasing gas and arranging for its supply and transportation to customers. Dealers may take title to the gas but maintain no physical plant.

Transporter

A transporter is a utility engaged in the practice of arranging transportation and supply of natural gas. A transporter may or may not take title to the gas but does maintain facilities for the transportation of natural gas.

Least-cost Purchasing

Least-cost purchasing is the optimal strategy that includes supplier reliability, supply contracts (long and short term) and other factors in addition to cost to obtain a firm supply of gas.

Merchant Function

The merchant function is defined as the purchase of natural gas for resale.

Unbundling of Service

Unbundling of service is the process by which a utility identifies the services available and assigns a separate rate for each service.

End-User

An end-user is a retail customer; one who consumes natural gas at the burner-tip.

OBJECTIVES

Recognizing that trade-offs between competing interests are necessary, the purposes of this investigation are as follows:

-- To ensure that all customers of an LDC have the opportunity to benefit from increased competition in the natural gas industry.

-- To maintain the economic and financial well-being of the natural gas distribution industry in Kentucky.

-- To expand the Commission's oversight of natural gas acquisition practices by LDCs.

-- To examine the Commission's authority in fulfilling its mandate to assure fair, just, and reasonable rates for natural gas customers in Kentucky.

-- To examine the extent to which LDCs should offer a variety of services in order to keep large volume end-users on their systems.

-- To encourage the economic use of natural gas produced in Kentucky.

After reviewing the testimony and data in this case, the Commission finds that its policies should be formulated to meet the following objectives:

1. To assure that LDCs pursue all avenues to acquire the lowest cost wholesale natural gas for their customers. This effort must not endanger the firm supply upon which many customers are dependent.

Most residential and commercial customers must rely on the LDC to purchase natural gas for them. Such customers realistically cannot arrange for their own natural gas supply or transportation due to the size and seasonality of their use. Historically, LDCs have relied on the interstate pipelines which purchased from a large portfolio of suppliers thus offering a reliable supply of gas to the LDCs. As interstate pipelines elect to become more involved in the transportation of gas (and move away from bearing the risk of the entire merchant function) LDCs must accept greater responsibility for maintaining a reliable and available supply of natural gas for customers who are paying for such service.

The Class A LDCs should prepare to assume more of the merchant function. In the pursuit of least cost wholesale natural gas, Class A LDCs should evaluate renegotiating their long term contracts and study the use of interstate and intrastate transportation services to gain access to spot market gas.

2. To promote the use of the existing retail distribution system by customers who arrange for their own supplies of natural gas.

In order to provide the most efficient system for gas distribution the Commission wants to avoid or minimize duplication of facilities. The Commission is of the opinion that transportation rates can be designed that will encourage use of the existing distribution network. Those customers who cannot realistically arrange for their own supply will benefit from contributions to fixed costs by other customers who are capable of arranging their own supply. Retaining former retail sales customers as retail transportation customers maintains a contribution to system costs.

Encouraging natural gas transportation increases the access of large volume end-users to lower priced natural gas supplies. Large volume end-users must have access to spot market natural gas to be competitive with other areas of the country that are encouraging use of alternate suppliers. As large volume end-users evaluate methods of reducing production costs, energy expense is one factor that they consider. The Commission wishes to encourage economic activity in Kentucky by eliminating unnecessary barriers to less expensive sources of energy.

3. To provide a regulatory framework in which the LDCs can effectively compete to supply large volume end-users.

As LDCs assume more responsibility for the merchant function of acquiring natural gas and transportation rates allow them to be more competitive, the economic incentive to maintain full service customers will increase. The Commission will evaluate programs that the LDCs may propose to compete for the large volume end-users.

4. To encourage Class A LDCs to participate in competition at the wholesale level for natural gas supply.

Although the Commission sees merit in the national program to have interstate pipelines become primarily providers of transportation services, the fact remains that there is much uncertainty at this time. Requests for Order 436 transportation tariffs are entangled with take-or-pay proposals at the Federal Energy Regulatory Commission ("FERC") and the entire order is being debated in Docket No. 85-1811, et al., before the United States Court of Appeals for the District of Columbia. Thus the Commission can only encourage LDCs to follow closely the activities of their pipeline suppliers and announcements by the federal government to further deregulate wholesale natural gas markets.

5. To establish a regulatory framework that is appropriate to the new structure of the natural gas industry.

In determining the degree of regulation of emerging companies in the natural gas retail sector, the Commission does not want to respond to deregulation at the national level with an unnecessary increase in regulation at the state level.

6. To evaluate unbundling of services and development of appropriate cost allocation methods.

The record in this case indicates Class A natural gas utilities and large volume end-users support unbundling of services as a means of encouraging competition. The Commission believes a study of each utility's cost allocation is a prerequisite to revising tariffs for unbundled services. The Commission will consider the results of such studies and the impact on individual customers in determining appropriate rates for unbundled services.

Unique Features of the Natural Gas Industry

Some background on the natural gas industry and its regulation is important for understanding the current environment. Due to the special characteristics of the industry, the federal government has regulated the price of natural gas through a variety of regulatory mechanisms since 1938. One of these characteristics is the degree of vertical integration. Companies owning transmission lines and controlling production companies have frequently been affiliated, raising questions of whether prices have been determined by arms-length negotiations. Another characteristic is the incentive required to encourage continued exploration for new reserves. Since natural gas is an exhaustible resource, the pricing system must be designed to encourage continued exploration for new reserves. This exploration is capital intensive.

Another feature of natural gas production is the allocation of production wells to intrastate and interstate markets. Over the years the interplay of natural gas committed to one market or the other has affected pricing. Prior to the Natural Gas Policy Act of 1978, producers attempted to avoid price regulation by dedicating newly discovered reserves to intrastate markets. Due to the nature of the natural gas industry, large producers are able to respond to regulatory programs by withholding reserves or reducing exploration for new reserves.

Producer contracts with pipeline companies often contain a take-or-pay clause which requires pipelines to pay for a certain volume of gas regardless of use. Most LDCs rely on pipeline companies to supply natural gas and are essentially price-takers. The structure of supply contracts in conjunction with near monopoly distribution service creates an inefficient market.

Federal Regulatory History

The structure of the natural gas industry has led to the need for government intervention. Initially, the Federal Power Commission ("FPC"), predecessor to FERC, focused its efforts on establishing the interstate price for large producers and assumed small producers would adjust their prices accordingly.

In 1962 the FPC changed to a system of area rates for producers. The producers were opposed to area rates, and drilling for new reserves fell 50 percent between 1960 and 1970. The lack of discovery of new reserves was a factor that led to natural gas shortages in the 1970's and the passage of the NGPA in 1978.

In 1974 the FPC implemented nationwide rates for producers based on two pricing mechanisms. The FPC set the price for old gas in the interstate market while the price for new gas in the interstate market was to be determined by market conditions at the time. The price for new gas was expected to be sufficiently high to encourage exploration.

During the shortages of the 1970's, the FPC permitted special 60-day emergency sales. The prices charged by producers for emergency sales were often double the cost-based rates. This resulted in producers holding back available supplies, speculating that the prices would go even higher. The FPC then agreed to allow higher prices for regulated gas and extended price regulation to natural gas in intrastate markets to achieve more stability of supply and price in the long run.

The NGPA further required FERC to allow pipelines to pass through the cost of their natural gas purchases to their customers, unless fraud and abuse could be shown. The statute defined fraud and abuse as any concealment or negligent misrepresentation. The ability of a producer to hold back reserves led state consumer advocates to suspect large producers of withholding low-priced reserves and moving higher priced gas.

About the same time, the world price of oil dropped. Oil and natural gas are substitutes in many industrial processes. As the price of oil dropped, industrial end-users switched to oil. The pipelines and LDCs saw their sales declining.

In Kentucky, all Class A LDCs experienced a drop in demand. Columbia saw demand by residential and commercial customers fall by 20 percent and 70 percent by industrials.[1] ULH&P,[2] Delta,[3] WKG,[4] and LG&E[5] experienced dramatic declines as well. The decline in demand by residential and commercial customers can be attributed to conservation resulting from increasing gas prices and warmer weather. The loss of industrial demand, however, was primarily the result of the drop in oil prices.

Transition, 1982-1985

In 1982 the decade-long rise in the producer's price of natural gas began to level off. However, between July 1982 and July 1983, the price of gas sold by interstate pipelines rose. Again, the price-sensitive industrial end-users reacted strongly.

Pipelines responded with action at both ends to reduce prices and lessen contractual take-or-pay liabilities. They renegotiated supply contracts, exercised "market out" clauses, and insisted on

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1 Columbia response to Commission's Order dated January 17, 1986, Question No. 2.

2 ULH&P response to Commission's Order dated January 17, 1986, Question No. 2, pages 2, 3, and 4.

3 Delta response to Commission's Order dated January 17, 1986, Question No. 2, page 2.

4 WKG response to Commission's Order dated January 17, 1986, Question No. 2, page 6.

5 LG&E response to Commission's Order dated January 17, 1986, Question No. 2.

more favorable terms in new contracts with producers. In addition, pipelines devised various market-segmenting tools to retain industrial end-users.

To assist the pipeline's market diversification, FERC approved a series of special marketing programs ("SMPs"). The SMPs allowed a pipeline to terminate a purchase contract with a producer and instead arrange to transport the gas to an end-user that purchased directly from the producer at a reduced price. FERC also expanded its "blanket certificate" programs granting generic approval for certain kinds of transportation service.

On May 10, 1985, the District of Columbia Circuit Court found the SMPs and blanket certificates to be discriminatory and invalidated both programs.[6]

Aware that the pipelines were facing a dilemma of growing natural gas supplies, high prices tied to long-term contracts, and reduced demand, FERC had been considering changes in its regulatory framework. The Circuit Court decision spurred FERC to formalize a proposal.

On May 30, 1985, FERC announced its plans in a Notice of Proposed Rulemaking ("NOPR"). The NOPR would advance the pro-competitive features of the earlier programs while eliminating their discriminatory aspect. All customers would be allowed nondiscriminatory access to transportation service for natural gas. If effective, a fully competitive market could evolve from

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6 Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir., 1985), and Maryland People's Counsel v. FERC, 768 F.2d 450 (D.C. Cir., 1985).

the producer to the end-user. Any market power of the pipelines would extend only to transportation services which would be subject to cost-of-service regulation.

The four parts of the NOPR would, first, allow pipelines to provide transportation with conventional certification. Second, an "optional, expedited certification" procedure would be offered. Third, pipelines accepting the optional certification procedure would be granted a "safe-harbor" for recovery of certain take-or-pay expenses that would be assumed prudent. Fourth, pipelines accepting the optional certification procedure would be subject to relaxed regulation of gas sales rates. This is a part of a broader attack on rolled-in pricing of natural gas.

On October 9, 1985, FERC issued Order 436, its final rule entitled "Regulation Of Natural Gas Pipelines After Partial Wellhead Decontrol." The stated purpose of the final rule was:

> . . .to assure that commodity and transmission prices for natural gas between the wellhead and burner-tip would be clear and accurate and consistent with the requirement of the Natural Gas Act of 1938 that rates and practices be just and reasonable and not unduly discriminatory, or preferential.[7]

The final rule established a framework for setting just and reasonable rates and practices for the sale and transportation of natural gas in interstate commerce. FERC authorized an effective date of November 1, 1985, for transportation of natural gas under the provisions of Order 436.

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7 33 FERC 61,007 "Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol," page I-10.

The final rule has certainly shaken the gas industry. Yet the record in this case indicates that the pipelines who serve Kentucky, except for CGT and TCO, have been slow to adopt the Order 436 approach. The effective date for transportation has been extended by FERC at least three times since the final rule was issued.

Given federal deregulation, the transition from monopoly to competition has become the responsibility of state regulatory commissions. The task confronting state regulators is to decrease the probability of unnecessary economic dislocation and ensure that the transition occurs at a minimum cost to all regions and groups. The question is not whether competition can exist; the fundamental question is how competition can function in the public interest.

The transition has forced LDCs to confront the problem of public utility obligations in a marketplace where the ground rules are changing. LDCs face potential challenges in both the world of competition and the world of regulation.

PSC JURISDICTION

At the conclusion of the hearing on January 7, the Commission requested briefs from the parties on the subject of its jurisdiction. The briefs generally reflect the particular interests of each party. The Commission has taken a broad view in determining the most appropriate degree of its regulation. The result is a comprehensive regulatory framework, one that attempts to adapt to the activities of the industry as a whole.

During the course of this proceeding, it became evident that there are a variety of companies that fall within the definition of utility under KRS 278, but which are not now regulated. These are companies involved in the production, sale, distribution, and transportation of natural gas. In order to protect the public and fairly enforce the statute, the Commission intends to regulate all entities that fall within the scope of the statute. It is essential that the Commission maintain an oversight role in the traditional aspects of the industry, although it may not be necessary to regulate to the same extent all aspects of natural gas related utilities. The Commission will look at new competition and regulatory proposals from the perspective of improving the LDCs' ability to compete on the retail level with alternate fuels and alternate transporters in the interest of all ratepayers. Accordingly, the Commission endeavors to structure its regulation to be compatible with the marketplace.

The Commission does not want to respond to deregulation at the national level with an increase in regulation at the state level that would stifle competition. However, to meet the Commission's goals and uphold its legislative mandate, regulatory intervention is necessary. The Commission believes that it has sufficient authority to carry out its duties, but will continue to monitor the needs of the public and the industry to determine the propriety of amending that authority. In addition to the statutory definitions, the Commission believes it is necessary to define emerging methods of conducting business in order to maintain effective regulation in the natural gas industry. There is no standard definition of "marketer" of natural gas. However, a significant number of comments were received concerning the Commission's regulation of "marketers." The services of marketers vary from one to another. Therefore, the Commission is establishing, on pages 6 and 7 of this Order, working definitions of broker, dealer, and transporter, all of which may have been previously considered as marketers.

The initial level of discussion concerning the Commission's regulatory approach is the wellhead. Producers traditionally have not been closely regulated. Neither their services nor rates have presented the Commission with the need to monitor on a wide scale. Changes in the gas industry could create situations where the Commission should become more involved. However, given the present competition in the marketplace, as discussed in the following section, the Commission finds there is no necessity to increase the degree of rate regulation of producers. The comments of the parties fully support this position.

The next level of activity involves transporters. Given the increase in demand for, and the provision of, transportation, the Commission finds it necessary to regulate any company that transports gas to the public for compensation. This includes any entity--producer, pipeline company, distributor or other person(s) --that has facilities used to transport gas. This is necessary in order to provide efficient use of existing facilities, avoid duplication of facilities, assure nondiscriminatory transportation, and encourage use of locally produced gas. The Commission is of the opinion that the facilities, practices, and services of transporters must be regulated to assure compliance with the objectives of this proceeding, while the rates charged for such transportation may be determined in the marketplace.

The final level of regulatory activity concerns distributors and sales of gas to end-users. Traditionally, the Commission has exerted full rate-base and facilities regulation of these entities. The Commission will continue to do so. The rates charged end-users, whether residential, commercial or industrial, remain a prime concern and are best maintained at reasonable levels by continuing review. The market may allow rates in certain competitive areas such as production and transportation to be somewhat self-regulating. However, because there is no real price competition at the retail sales level, the Commission must retain its historical role as a substitute for the marketplace.

In summary, any utility selling gas to the public, whether it has historically been considered as producer, transporter, LDC, or otherwise, is subject to full rate-base and facilities regulation. The Commission considers the public to be one or more end-users. The sale of gas to the public supersedes other business activities of a utility and subjects it to aforesaid level of regulation. For example, a pipeline company or producer that generally transports gas, but which sells some of its gas to an end-user, will be considered a distributor and seller of natural gas. In order to maintain fair and effective regulation of all companies engaged in similar activities, equivalent oversight of comparable activities is required. Pursuant to KRS 278.485, farm taps are exempted from this regulation.

Certain other entities, i.e., brokers and dealers, were reviewed during the course of this proceeding to determine their place in the changing gas industry. At this time, the Commission finds it is unnecessary to regulate brokers and dealers. Both entities are engaged in arranging supplies of gas. While this may affect other phases of the market, the market realities of such activities are sufficient to be self-regulating. The Commission is aware that there are companies engaged in utility activities pursuant to KRS 278 that were previously unknown or did not consider themselves subject to regulation. The Commission finds that all utilities, which have not previously done so, should file their current tariffs, system maps, and a description of their business activities.

Subsidiary Operations

As brokers and dealers are to be unregulated, the Commission is of the opinion that it should continue to allow LDCs to operate subsidiaries for the same purpose. The subsidiary will be unregulated as are other brokers, but the Commission will review the operation of the regulated company to determine that no cross-subsidy occurs. The Commission reserves the right to examine the books and records of the subsidiary. In the interest of fair competition, information known to the subsidiary must also be available to other brokers.

COMPETITION

In the Order establishing this proceeding, the following questions were asked: "Should the Commission encourage competitive markets in natural gas supply and in transportation services?"

The responses indicate the Commission should encourage competition in retail natural gas supply and retail transportation services. However, there were divergent opinions on the meaning of increasing competition in the retail sector of the natural gas industry. Stand Energy[8] and KIUC[9] believe the Commission should encourage competition in all markets related to natural gas supply including gas sales, brokerage, transportation, and storage. In the opinion of Entrade, the Commission should encourage competition to insure responsive prices for all customers including captive customers.[10] In Xebec's opinion, the Commission should encourage competition by prohibiting LDCs from operating brokering/marketing affiliates.[11] Southwire believes that the price of gas and the fee for delivery service should both be set by competitive market forces.[12]

Although Class A LDCs generally support pro-competitive policies, they have expressed concern about the impact on their traditional role as a reliable supplier and the regulatory encumbrances that will affect their ability to compete in retail

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8 Stand Energy response to Commission's Order dated January 17, 1986, Question No. 18.

9 KIUC response to Commission's Order dated January 17, 1986, Question No. 18, page 16.

10 Entrade Motion to Intervene dated February 6, 1986.

11 Xebec response to Commission's Order dated January 17, 1986, Question No. 18, page 5.

12 Southwire response to Commission's Order dated January 17, 1986, Statement of Purpose, page 2.

supply and transportation markets. Both Delta[13] and LG&E[14] expressed concern that as competition increases, services may become less reliable. Delta is of the opinion that all competitors should be regulated to the same degree.[15] WKG thinks competitive markets should result in "cost-of-service" rates.[16] According to Columbia, the Commission should encourage competition in a manner that avoids duplication of facilities and ensures uniform regulation.[17]

The AG summed up the situation by stating its reason for participating in this case as follows:

> To encourage the Commission to adopt a market driven, jobs producing, innovative regulatory policy for the competitively driven sector of the natural gas market and a system of reasonable regulatory controls for the noncompetitive segment of the market.[18]

Large volume end-users were asked what factors limit their participation in competitive natural gas markets. KIUC's response is representative of the other responses in citing three factors: one, restrictive tariffs of interstate pipelines and hesitation in

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13 Delta response to Commission's Order dated January 17, 1986, Question No. 18, page 15.

14 LG&E response to Commission's Order dated January 17, 1986, Question No. 10e, page 2.

15 Delta response to Commission's Order dated January 17, 1986, Question No. 18, page 14.

16 WKG response to Commission's Order dated January 17, 1986, Question No. 18, page 26.

17 Columbia response to Commission's Order dated January 17, 1986, Question No. 18, page 24.

18 AG response to Commission's Order dated January 17, 1986, page 4.

adopting Order 436; two, restrictive tariffs of LDCs; and, three, excessive transportation rates.[19]

GTE stated that high transportation costs within the state limit its participation in competitive retail natural gas markets.[20] Southern believes its output could be increased substantially if present hindrances to competition were eliminated and transportation capacities to local and interstate markets were made available.[21]

The Commission recognizes the effect of competition at the retail level in natural gas supply. The Commission encourages the efficient allocation of physical and financial resources and recognizes that competition may be a means to achieve this. A reduction in regulatory barriers to transportation should promote this goal. Thus, competition will be directed to the actual cost of the gas itself. This is desirable, as the cost of gas is the largest single factor in any gas sales rate, and is where the greatest savings may be achieved.

<u>ACQUISITION PRACTICES</u>

In January 1985 the provisions of the NGPA that were linked to the deregulation of natural gas prices at the wellhead became effective. Concurrently, FERC proposed changes to the regulation

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19 KIUC response to Commission's Order dated January 17, 1986, page 17.

20 GTE response to Commission's Order dated January 17, 1986, Question No. 18b, page 18.

21 Southern response to Commission's Order dated January 17, 1986, page 9.

of interstate pipelines that were intended to promote competition. One of FERC's goals was to allow LDCs access to a larger number of suppliers in order to take advantage of lower wellhead prices.

One of the Commission's purposes in this case was to determine the need for change in, or expansion of, its oversight of LDCs' gas acquisition practices in order to encourage participation in wholesale natural gas markets. Most of the responding LDCs indicated they expected some change in their acquisition practices. LG&E expressed the concern of several LDCs that least-cost gas be made available to its customers:

> If given access to nondiscriminatory transportation services, the company expects to exercise its right to participate in the spot market for a portion of its gas supply, thus possibly realizing even greater short-term savings.[22]

LDCs are also quite concerned that the dependability of supply, necessary to serve firm customers, not be jeopardized. This concern is evident in Columbia's statement:

> Columbia intends to purchase only firm gas supplies to meet the requirements of its firm markets. Whether that firm supply is purchased from interstate pipelines or directly from producers or brokers, will depend upon supply availability, price, transportation rates and pipeline capacity.[23]

The AG considered the acquisition review, proposed in the Draft Order, as desirable but indicated the Commission's proposal might not go far enough. The AG suggested a statewide econometric

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22 LG&E response to Commission's Order dated January 17, 1986, Question No. 10b, pages 1 and 2.

23 Columbia response to Commission's Order dated January 17, 1986, Question No. 10b, page 2.

model or gas sharing arrangements among LDCs as being more effective in efficiently meeting the demand for gas.[24]

The LDCs indicated further areas of concern: designing contract provisions to accommodate the changing market, avoiding take-or-pay exposure, taking advantage of spot-market purchases, evaluating deliverability of suppliers to ensure dependable service and tying gas prices to other fuel prices. As Delta stated, the primary concern is to maintain supply and market flexibility.[25] TCO, Columbia Gulf and all of the Class A LDCs stressed that while LDCs have an obligation to pursue least-cost gas for their customers, the purchases and contracts entered into must be consistent with preserving a reliable supply.

Although one of the Commission's objectives is to direct Class A LDCs to acquire least-cost wholesale natural gas, there continue to be market barriers in the wholesale gas market. The primary barriers are the slow movement by interstate pipelines in actually moving gas under Order 436 and the reluctance of producers to renegotiate high take-or-pay contracts. Despite federal regulatory efforts to the contrary, allocation of pipeline capacity by interstate pipelines that have declared themselves open transporters is also a barrier.

Among the questions asked in this docket was: "What factors limit LDC participation in competitive natural gas markets?" As

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24 AG's response to Commission's Order dated September 30, 1986.

25 Delta response to Commission's Order dated April 18, 1986, pages 1 and 2.

LG&E explained, most LDCs are currently unable to reduce their sales contract demand with their wholesale suppliers and replace them with firm transportation service.[26] Columbia believes participation is limited by existing contracts, limited access to spot markets and regulatory constraints.[27] Delta raised the discrimination question of reduced rate service to some customers as a potential obstacle.[28]

Several commenters mentioned regulatory constraints as an obstacle to participation in competitive natural gas markets. The Commission initiated this case to examine the appropriate role of regulation in the natural gas sector given the federal policy changes, and has determined that the public interest requires an increased oversight role in the area of natural gas acquisitions.

In anticipation of changes in gas procurement, Class A LDCs should examine their forecasting methodology and their ability to accurately project natural gas demand. As supply contract periods change, better information on demand will assist the LDC in matching demand with the least cost supply. Class A LDCs should expect an inquiry into forecast methodology by the Commission as part of the acquisition review process.

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26 LG&E response to Commission's Order dated January 17, 1986, Question No. 18a, page 12.

27 Columbia response to Commission's Order dated January 17, 1986, Question No. 18a, page 24.

28 Delta response to Commission's Order dated January 17, 1986, Question No. 18a, page 15.

The Commission believes that Class A LDCs should consider new contract provisions to obtain natural gas at market clearing prices. These provisions could include, but are not limited to, shorter term contracts, annual price renegotiation, or linking price to an indicator that changes with market conditions.

The Commission encourages Class A LDCs to diversify their wholesale suppliers to the extent necessary to take advantage of lower wellhead prices and maintain reliable supply. Pursuant to KRS 278.507 (1), it will be the policy of the Commission to facilitate greater use of natural gas produced or available for production within the state, where this can be done without detriment to the other ratepayers. In addition, pursuant to KRS 278.274 the burden will be on the utility to defend the company's portfolio of suppliers, the extent to which lower cost gas supplies have been pursued, the terms of new supply contracts, and the reliability of supply to those customers dependent on firm supply service.

Maintaining a reliable supply of natural gas is not simple, especially in light of federal deregulation. Given these changes, the Commission will thoroughly investigate and evaluate LDCs' future purchasing plans and their effect on consumer rates and supply reliability. The framework for this evaluation for Class A gas utilities will differ from that for all other gas utilities. A more structured approach is being established for Class A LDCs to ensure that they are active in deregulated markets and they seek to obtain the least-cost reliable supply of natural gas.

When asked about the timing of acquisition reviews, LDCs gave somewhat varying opinions. Delta was of the opinion that the first review should come during the next rate case of each company.[29] WKG thought the reviews should begin at once;[30] LG&E suggested a delay of one year.[31] Delta,[32] LG&E,[33] and ULH&P[34] felt an annual review was too frequent and not cost effective, suggesting every 2 to 3 years instead; Columbia was concerned about regulatory lag and suggested timing periodic reviews to fit into each company's planning cycle.[35] Delta would time the reviews coincident with the "normal gas year" beginning November 1.[36] LG&E suggested conducting the reviews in late winter or early spring,[37] and ULH&P the first or second quarter.[38] Several of the LDCs pointed out that the purchased gas adjustments ("PGAs") afford the Commission an on-going opportunity to monitor acquisitions.

The Commission plans an in-depth annual review of the purchasing practices of each Class A LDC. Although termed a review, the focus will be prospective in nature and will fit, as

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29 Transcript of Evidence ("T.E."), January 7, 1987, page 30.

30 Ibid., page 120.

31 Ibid., page 80.

32 Ibid., page 31.

33 Ibid., page 80.

34 Ibid., page 169.

35 Ibid., pages 136-137.

36 Ibid., page 31.

37 Ibid., page 81.

38 Ibid., page 170.

much as possible, into established planning cycles. The Commission is of the opinion that the first step of each review should be the submission by the LDC of its long-term supply and demand forecast and portfolio of natural gas suppliers, including details of the producers' and transporters' contracts. The Commission will review the extent of long term planning, as well as the pricing mechanisms and mix of long term and spot purchases. This information will be used in evaluating responsiveness to deregulation within the given constraints.

The acquisition review process should begin in August 1987 with each Class A LDC filing the details of any demand forecast and acquisition planning procedures already in place. This information should be supplied from both the 1986-87 and 1987-88 heating seasons in order to make the Commission familiar with current status of acquisition planning for each company. The filings will be accepted as information to be used in structuring future acquisition reviews; and, unless otherwise notified, no further action shall be taken. The timing of the review for each company will depend on the company's established planning cycle. The Commission will notify each Class A LDC of its annual filing cycle after reviewing its established procedures. The implementation of each LDC's acquisition plan will be reviewed on an on-going basis through its gas cost adjustment filings. The Commission does not intend to monitor adherence to the plan itself, but to be assured of least-cost planning and acquisitions.

For smaller gas utilities the Commission will periodically conduct a prospective review of acquisition practices as part of purchased gas adjustment filings and general rate cases. Such proceedings provide the Commission a means of encouraging long-term planning and reviewing prudency of purchases.

The Commission will continue to intervene in cases before FERC that affect the wholesale suppliers of Kentucky's LDCs. The Commission encourages all Class A natural gas companies to become active participants in cases and activities that involve their wholesale suppliers.

The importance of active intervention will increase as pipelines agree to serve as transporters. The pipelines will propose new rate designs and allocation methods for transportation that will have a direct bearing on the LDCs' retail services. For example, TCO mentioned the use of Seasonal Volumetric Obligations (SVOs).[39] SVOs are seasonal quantities nominated by TCO's customers to define TCO's service obligations to its wholesale customers. To effectively evaluate and participate in TCO's SVO program requires good information on customer demand.

Incentives In Gas Acquisition

In answer to the Commission, at the January 7, 1987, hearing interested parties testified regarding what incentives could be built into gas purchasing. Delta described two changes necessary to build in incentives: one, eliminating purchased gas adjustment

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39 TCO's response to Commission's Order dated April 18, 1986, pages 1 and 2.

clauses; and, two, providing shareholders a means of retaining a portion of gas savings below target level.[40]

LG&E noted that important incentives already exist in gas purchasing. According to LG&E, LDCs have an incentive to obtain low cost gas in order to maintain overall customer satisfaction, especially from industrial customers who can switch to other sources of energy. LG&E expressed interest in incentives that permit sharing of gas cost savings but wanted careful study before implementation.[41]

WKG added the idea of an increased rate of return allowance for a company that does especially well in managing gas procurement.[42] Columbia saw some merit in the idea of an incentive system but had no specific plan to offer.[43] Both Columbia and ULH&P mentioned increasing allowed rates of return for LDCs that performed well and sharing in gas cost savings below a benchmark level.[44]

Competition from other gas suppliers and other sources of energy can provide the most effective incentive for actively seeking lower gas supply costs. The use of weighted average cost of gas in rate design spreads this incentive among industrial customers with supply alternatives and all other customers. The

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40 T.E., pages 35-37.

41 Ibid., pages 83-84.

42 Ibid., page 123.

43 Ibid., pages 140-142.

44 Ibid., pages 171-172.

Commission will carefully review proposed rate designs to consider their effect on gas purchasing incentives.

As pointed out by LG&E,[45] active Commission oversight is an important incentive. The Commission has discussed previously in this Order how it is expanding its oversight of LDCs' gas acquisition practices.

A policy allowing LDCs to retain a portion of gas savings below a benchmark level, if well constructed, could provide an additional incentive. Determining the appropriate benchmark and portion to be shared is difficult. Errors in forecasting or unforeseen circumstances could result in significant windfalls or losses for LDCs. A partial pass-through mechanism could have unintended influences on an LDC's choice of supplier mix, contract duration and other contract terms. However, the Commission will continue to review evolving gas markets and LDC gas acquisition practices to determine if additional incentives from a partial pass-through method would be in the public interest.

UNBUNDLING OF SERVICES AND RATES

Rate design change offers one means of resolving gas market concerns. Historically, gas purchases involved "full-service" which included transportation, brokerage, storage, load-balancing, and sometimes gas production and marketing. The latest trend in rate design is a "self-serve" approach of unbundling natural gas rates in response to competition. KIUC stated that rates for transportation services should be unbundled and based on the cost

[45] Ibid., page 83.

of providing the service.[46] In Delta's opinion, individually priced services would provide greater selection for customers with larger loads.[47] However, Delta is concerned that unbundling of services would result in higher prices for the majority of its customers who are residential or small commercial customers.[48]

In LG&E's opinion, natural gas rates should be unbundled only to the extent of separating the cost of gas supply from the distribution system.[49] WKG thinks sales rates must be unbundled and transmission services priced separately in order for the LDC to discourage bypass of its distribution system.[50]

ULH&P believes that any transportation program should provide the LDC as much flexibility as possible given market conditions and federal and state regulatory policies.[51] In order to properly meet these objectives, ULH&P believes that rates should be unbundled to reflect the services provided by the LDC and such services should be billed separately.[52] Southwire supports the

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46 KIUC response to Commission's Order dated January 17, 1986, Question No. 15a, page 10.

47 Delta response to Commission's Order dated January 17, 1986, Question No. 15, page 9.

48 Delta response to Commission's Order dated January 17, 1986, Question No. 15, page 10.

49 LG&E response to Commission's Order dated January 17, 1986, Question No. 15, page 8.

50 WKG response to Commission's Order dated January 17, 1986, Question No. 15a, page 19.

51 ULH&P response to Commission's Order dated January 17, 1986, Question No. 15, page 10.

52 Ibid.

goal of unbundling the services offered by gas companies so that customers are not forced to purchase services which they do not want or need.[53]

Stand Energy believes that natural gas rates should be unbundled.[54] In the opinion of Xebec, natural gas rates should be unbundled to encourage maximum use of available pipeline capacity, and to provide more timely response to competitive market pricing signals.[55]

However, as Columbia pointed out, it is apparent that the current FERC policy reflects a departure from the average cost rate-making concepts.[56] Columbia thinks fully allocated rates based on cost responsibility, coupled with the ability of flex rates to meet competition, will better serve the needs of all gas customers.[57] In Columbia's opinion, future rate design must give appropriate weight to flexibility, adaptability, experimentation, and "what the market is willing to pay."[58]

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53 Southwire response to Commission's Order dated January 17, 1986, page 3.

54 Stand Energy response to Commission's Order dated January 17, 1986, Question No. 15.

55 Xebec response to Commission's Order dated January 17, 1986, Question No. 15, page 4.

56 Columbia response to Commission's Order dated January 17, 1986, Question No. 10d, page 3.

57 *Ibid.*

58 Columbia response to Commission's Order dated January 17, 1986, Question No. 15, page 15.

The AG believes that the Commission must act to provide non-discriminatory and equal access to (intrastate) pipeline transportation services, to require the unbundling of all the functions provided by (intrastate) pipelines, and to base rate levels on the cost of providing each service (although a phase-in period may be necessary).[59]

KIUC discussed the decision of the Pennsylvania Public Utility Commission to move away from gross margin transportation rates to cost-based transportation rates. KIUC stated its belief that a similar decision in Kentucky would benefit both industrial and residential customers.[60] KIUC found industrial customers would benefit because they could compete on even terms with industries in other states for low cost self-help gas.[61] Residential or "captive" customers would benefit because industrial customers would not resort to increasingly cheaper alternate fuels and leave the system entirely according to KIUC.[62]

In order to implement unbundled rates, the Commission finds it prudent to pursue a moderate course of action. Rapid changes in rate structure can result in unacceptable levels of economic

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59 AG response to Commission's Order dated January 17, 1986, page 4.

60 KIUC response to Commission's Order dated January 17, 1986, Question No. 15c, page 11.

61 KIUC response to Commission's Order dated January 17, 1986, Question No. 15, page 13.

62 Ibid.

dislocation threatening reliable service and the financial health of some natural gas companies.

The Commission notes that to some extent all Class A LDCs have unbundled services and rates. All provide a transportation service; some provide gas storage; and others offer a brokering service. The Commission is of the opinion that all Class A LDCs should continue to offer and provide separate rates for the sale and transportation of gas.

For those customers who use the transportation service, each Class A LDC shall also offer a standby service at a separately identified rate. The purpose of standby service is to allow a transportation customer the option of "reserving" access back on the LDC's system as a sales customer. If a utility needs to revise its tariff to include a rate for standby service, the revised tariff shall be filed no later than its next rate case. Appropriate cost support is required with such filing.

In addition, each Class A LDC shall review its own situation relative to its customers' needs and its need to compete. Any service offered by the LDC shall be identified separately in its tariff with a specific rate. The burden of proof shall be on the LDC to demonstrate that it does not have the capability to provide a requested service, or for other reasons should not offer a service.

Additional services that could be provided include storage and brokering. However, the Commission is concerned that brokering may target less expensive gas to certain customers to the detriment of other customers. To the extent brokering is used to keep large-volume end-users on the LDC's system, the Commission is of the opinion that an appropriately designed transportation rate should be able to achieve the same result. Therefore, the Commission will monitor brokering services by LDCs in order to prevent any negative impact on customers who are unable to use such a service. The Commission will also monitor LDC brokering services to ensure that they compete fairly with non-LDC brokering services.

All other utilities shall review their own particular situation to determine what services should be provided in order to compete or that may be requested by its customers. Each service provided shall be identified individually in the utility's tariff with an appropriate rate.

<u>COST-OF-SERVICE</u>

The record indicates a significant amount of discussion concerning cost-of-service. While the subject itself has been questioned, it has also been included in answers to questions on competition and natural gas markets. In Columbia's opinion, cost-of-service should be a first step in unraveling existing distortions between rate schedules and in the design of rates which transmit accurate price signals regarding the cost-of-service.[63] Across-the-board rate increases and average cost of gas PGAs clearly distort the communication of accurate price signals.[64]

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63 Columbia response to Commission's Order dated January 17, 1986, Question No. 15c, page 16.

64 *Ibid.*, Question No. 15f, page 18.

Both TCO and Columbia Gulf support cost-based rate-making at the federal and state levels consistent with providing the flexibility necessary to compete for markets.[65] GTE supports the adoption of unbundled cost-based rates.[66] In its opinion, fully-allocated, cost-based rates with class-equalized rates of return will benefit GTE in its gas transportation program.[67] KIUC thinks the Commission, as part of this proceeding, should require LDCs to develop fully allocated, embedded cost-of-service studies showing the cost-of-service rate for each proposed class of transportation and each class of gas sales.[68] LG&E thinks cost-based rates are desirable and should be pursued unless other overriding issues exist.[69]

Southern states that since marginal rates are not fully allocated cost-based rates, some customers are charged an unfair economic rent for transportation facilities and subsidize other customers.[70] In the opinion of WKG, now is the time to move

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65 TCO and Columbia Gulf Joint response to Commission's Order dated January 17, 1986, Question No. 15c, page 8.

66 GTE response to Commission's Order dated January 17, 1986, page 1.

67 Ibid., Question No. 10d, page 3.

68 KIUC response to Commission's Order dated January 17, 1986, Question No. 15g, page 15.

69 LG&E response to Commission's Order dated January 17, 1986, Question No. 15e, page 9.

70 Southern response to Commission's Order dated January 17, 1986, Question No. 14, page 17.

toward cost-based rates.[71] According to WKG, both the LDC and the Commission must recognize today's market, and move quickly to prevent or avoid further load loss to alternate fuels.[72] Further, WKG thinks the only logical way to "level the playing field" is to allow the LDC to compete on a cost-of-service sales rate and correspondingly a cost-of-service transportation rate--not one without the other.[73]

In its Draft Order the Commission concluded that since each LDC operates in a unique environment, the determination of relevant costs and costing methodology may be equally unique. The Draft Order proposed requiring cost-of-service studies by each Class A LDC to be submitted in any proposed changes to rate design in the next rate case.

At this point it is important to discuss the role of cost-of-service studies relating to rate design. Columbia stated, "Since rate design has to consider marketability and many other factors, cost of service studies just serve as more or less a guideline in any case."[74] NSA maintained that the Commission should go forward with the unbundling of services and the adoption of cost-of-

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71 WKG response to Commission's Order dated January 17, 1986, Question No. 10d, pages 7 and 8.

72 *Ibid.*

73 WKG response to Commission's Order dated January 17, 1986, Question No. 15c, page 20.

74 T.E., page 143.

service transportation rates.[75] In Delta's opinion ". . .in choosing from amongst alternatives in a cost of service study differences of opinion will arise as to how that study should have been done."[76]

Delta said, "[cost-of-service studies] would include recommendations on the possible de-averaging of the cost of gas and how to assign that cost by customer class. This is an area that Delta very strongly believes must be addressed."[77] Columbia[78] and LG&E[79] agree that a rate case is the appropriate means by which to examine cost-of-service studies.

The position of the AG is that, "Other factors within the Commission directions, such as rate stability and so on, are much more important than cost allocation in setting the exact rates that each customer should pay."[80] ULH&P commented, "Obviously those commenters who argue for true cost-of-service rates are the same customers who are most capable of using alternative supplies."[81]

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75 NSA response to Commission's Order dated September 30, 1986, page 2.

76 T.E., page 39.

77 Delta response to Commission's Order dated September 30, 1986, page 4.

78 T.E., page 144.

79 T.E., page 85.

80 AG response to Commission's Order dated September 30, 1986, page 14.

81 ULH&P response to Commission's Order dated September 30, 1986, page 6.

The Commission is interested in cost-of-service studies because they provide a starting point in rate design. However, they are only one factor that the Commission will consider in designing rates. The Commission believes that other principles such as adequacy, efficiency, equity, and rate stability are equally important in designing rate structures.

The principle of efficiency seeks to minimize the total resource cost associated with the supply of natural gas. Rate stability is achieved by minimizing the impact of economic dislocation due to changing rate structures. Further, equity demands an adequate structure that will enable the utility to earn a capital-attracting rate of return. The role of the Commission is to ensure that these principles are properly balanced in the rate-making process.

The Commission finds that cost-of-service studies should be completed by each Class A LDC operating in Kentucky. The Commission will consider fully allocated cost studies. The purpose of the study should be to disaggregate services and assign the appropriate cost to each service. The studies should be logically consistent and reproducible, in the sense that any interested party with some understanding of cost allocation techniques could work his way through the numbers. The studies should begin with basic accounting, financial, cost, and system planning data so that the Commission or others may use the same cost and data to prepare studies using different allocation systems. The Commission prefers that the studies be disaggregated to the greatest extent possible. Moreover, the models should be available so that alternative assumptions and allocations could be examined.

The Commission would like to more thoroughly analyze the use of weighted average cost of gas principles in rate design. The term "de-averaging" is sometimes referred to as an alternate principle of allocating the costs of gas to individual customer classes. The Commission requests that cost-of-service studies also consider how the costs of gas differ by customer class. The studies should include recommendations on the possible de-averaging of the costs of gas and how to assign that cost by customer class.

Submission and Selection of Cost-of-Service Studies

In its January 17, 1987, Order the Commission requested further testimony regarding cost-of-service studies as proposed in the Draft Order. The Commission specified timing the submission of cost-of-service studies and appropriate methodology to be used as topics for discussion.

Southern asked the Commission to reconsider and revise the parts of its Draft Order which would only allow consideration of any change in actual rates, rate design, or additional tariff offerings of Class A LDCs in a rate case upon completion of cost-of-service studies.[82] KIUC expressed concern and confusion that the language of the Draft Order would literally require consumers to await the voluntary filing of changes in rate design

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82 Southern response to Commission's Order dated September 30, 1986, page 2.

and allocation at the pleasure and convenience of the LDCs.[83] Southwire[84] and Western[85] also expressed concern about the timing of cost-of-service studies.

LG&E asked the Commission to clarify that it could amend its tariff, simply to provide a minimum volume requirement or other minor conforming revisions without a full-blown rate case.[86] LG&E further stated, ". . .it is unclear why such studies should be undertaken immediately, where they are likely to become outdated before an LDC's next rate case and may result in duplicate studies which are time-consuming and expensive to prepare."[87]

Southern stated that the Draft Order should be revised to make clear that Class A LDCs complete transportation cost-of-service studies and promulgate cost-based transportation rates forthwith, and that present transportation tariffs remain in effect pending the implementation of such cost-based rates.[88] Southern was also of the opinion that the Commission had taken a step backward and was eliminating so-called downward flexibility

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83 KIUC response to Commission's Order dated September 30, 1986, pages 3 and 4.

84 Southwire response to Commission's Order dated September 30, 1986, page 4.

85 Western response to Commission's Order dated September 30, 1986, page 8.

86 LG&E response to Commission's Order dated September 30, 1986, page 4.

87 LG&E response to Commission's Order dated September 30, 1986, page 4.

88 Southern response to Commission's Order dated September 30, 1986, page 10.

in marginal transportation rates currently in effect to meet competition from alternate energy.[89]

The Commission has again reviewed the record concerning submission of cost-of-service studies and finds they should be submitted in the next rate case of each Class A LDC. As cost-of-service studies are used in determining cost allocations across all customer classes, they cannot be separated from a rate case. The decision to file a rate case is appropriately left to each utility. However, when the Commission has an issue that requires a company response it uses an investigative procedure. In the event a significant interval of time should pass before a Class A LDC files a rate case with a cost-of-service study, the Commission may require a response from that LDC. Regarding Southern's concern about flexibility, the Commission will continue to allow a flexible rate provision. Finally, the Commission confirms LG&E's commentary that conforming tariff changes, not involving rates, will be considered outside a rate case.

Selection of Cost-of-Service Methodology

In answer to the Commission's January 17, 1987, request for testimony, Delta stated, "We do not feel that a generic approach to cost-of-service studies is appropriate."[90] LG&E[91] and WKG[92] agreed with Delta.

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89 Southern response to Commission's Order dated September 30, 1986, page 10.

90 T.E., page 38.

91 T.E., page 85.

92 T.E., page 110.

GTE said the Commission had not had the time or received adequate testimony about the merits or deficiencies of available cost-of-service methodologies to select one or two and impose them on all LDCs.[93] GTE suggested that the Commission consider the question of an appropriate methodology on a case-by-case basis.[94]

In the opinion of Southwire, the Commission could avoid delay by setting a timetable for the filing of a rate case based on cost of service and for a generic consideration of appropriate cost-of-service methodologies.[95] The AG stated, "The Commission should consider cost allocation studies after it has established a fair and uniform methodology or set up a range for the studies as suggested by the AG, but it should not slavishly follow them or suggest that somehow they yield a 'correct answer.'"[96]

WKG encouraged the Commission to set up a conference with each utility to discuss how the cost-of-service study should be filed and what methods should be used.[97]

The record indicates that the parties have different opinions concerning the selection of a cost-of-service methodology. The LDCs and GTE generally prefer a case-by-case decision on cost allocation methodologies. Southwire and the AG recommend a

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93 T.E., page 178.

94 Ibid.

95 Southwire response to Commission's Order dated September 30, 1986, page 6.

96 AG response to Commission's Order dated September 30, 1986, pages 13 and 14.

97 T.E., page 105.

generic approach. KIUC believes the coincident demand or peak responsibility method explained in Gas Rate Fundamentals is most appropriate.[98]

The Commission finds that there are significant differences among Class A LDCs that merit case-by-case decisions on cost-of-service methodologies. The Commission is of the opinion that each Class A LDC should schedule an informal conference early in the development of its cost-of-service study. The Commission staff, as well as intervenors from the company's last rate case, should be invited to participate.

As several commenters stated, there are a variety of techniques available for cost-of-service studies. The Commission acknowledges that there is not a single acceptable method to prepare such a study. Each LDC is encouraged to choose the method it finds appropriate.

The Commission is concerned about cost-of-service methodologies that place all the emphasis on maximum design day as a way to allocate costs. This method may result in an inappropriate shift of costs to the residential customer class. For this reason, cost-of-service methodologies should give some consideration to volume of use.

TRANSPORTATION

Burden of Proof

In accord with KRS 278.490 and KRS 278.505, transportation should be contingent only on the availability of adequate capacity

[98] T.E., page 197.

to deliver the gas. As long as utilities have unused capacity in their systems, transportation will help maximize the efficient use of those facilities.

In this case, the Commission asked the question of who should bear the burden of proof when a request for transportation service is made. GTE,[99] KIUC,[100] Southern,[101] and Stand Energy[102] support placing the burden of proof on utilities to show they cannot transport natural gas upon request. According to Southern, there would be no practical or theoretical way for a customer to prove that the utility's system had transportation capacity which the utility denied it had; conversely, the utility could easily demonstrate such lack of capacity if it exists.[103]

LG&E believes the burden of proof should fall on the one proposing the transportation.[104] WKG is neutral on shifting the burden of proof.[105] In WKG's opinion, if a regulated utility holds itself out to be an open access transporter, the proper

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99 GTE response to Commission's Order dated January 17, 1986, Question No. 12d, Page 6.

100 KIUC response to Commission's Order dated January 17, 1986, Question No. 12d, Page 5.

101 Southern response to Commission's Order dated January 17, 1986, Question No. 12, page 13.

102 Stand Energy response to Commission's Order dated January 17, 1986, Question No. 12.

103 *Ibid*.

104 LG&E response to Commission's Order dated January 17, 1986, Question No. 12d, page 5.

105 WKG response to Commission's Order dated January 17, 1986, Question No. 12d, pages 12 and 13.

forum is already in place to require the utility to show cause before the Commission why it cannot transport a particular supply of natural gas.[106]

The Commission is of the opinion that the LDC is best able to determine the capacity of its system. The burden of proof should rest on the LDC to show why it cannot transport gas. This responsibility will require the LDC to disclose distribution capacity information to avoid duplication of facilities. While this provision avoids undue restriction of large volume end-users access to cheaper sources of natural gas, it allows competition to develop when surplus capacity on the LDC is not available.

Priority of Service

In its January 17, 1986, Order the Commission asked, "What should be the priority on allocating transportation and supply capacity of the LDC among its customers?" Columbia responded, "(t)he protection of high-priority gas consumers and the integrity of their supplies on either a peak or annual basis must be assured."[107] Delta assigned top priority to full-service loads supplied by the LDC, followed in descending priority by interruptible LDC loads, firm transportation and interruptible transportation.[108] WKG proposed an extensive priority arrangement

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106 Ibid.

107 Columbia response to Commission's Order dated January 17, 1986, Question No. 13, page 12.

108 Delta response to Commission's Order dated January 17, 1986, Question No. 13, page 7.

headed by sales customers under the LDCs' historic curtailment categories (i.e., preference to firm and high priority users).[109]

LG&E simply stated that supply and transportation capacity should always be allocated such that human needs requirements are satisfied before all other requirements.[110] GTE also recognized the human element in its comment that priority within a class during a gas shortage should be based on social needs, as are the existing allocation categories, and not on transportation versus retail.[111]

KIUC[112] and Xebec[113] shared the opinion that all types of firm service should receive priority over all types of interruptible service.

In its Draft Order, the Commission proposed that firm service should have priority over interruptible service within the guidelines of current curtailment tariffs. Comments filed by KIUC in response to the Draft Order supported the Commission's proposal.[114]

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[109] WKG response to Commission's Order dated January 17, 1986, Question No. 13, page 16.

[110] LG&E response to Commission's Order dated January 17, 1986, Question No. 13, page 6.

[111] GTE response to Commission's Order dated January 17, 1986, Question No. 13, page 8.

[112] KIUC response to Commission's Order dated January 17, 1986, Question No. 13, page 6.

[113] Xebec response to Commission's Order dated January 17, 1986, Question No. 13, page 3.

[114] KIUC response to Commission's Order dated September 30, 1986, page 2.

During the subsequent hearing on the Draft Order, GTE[115] and Columbia[116] testified that there is no difference between firm sales and firm transportation in terms of quality of service received; therefore, there should be no difference in curtailment priority between the two. Delta, in its testimony, sought to define two types of curtailment and distinguish curtailment priorities depending on whether the need for curtailment arose because of facility constraints or supply shortages.[117]

The Commission is of the opinion that a distinction may be made in reasons for curtailment. In general, the Commission finds that firm sales and firm transportation should always be awarded a higher priority than interruptible sales and interruptible transportation.

It is reasonable that when a supply shortage develops, the one using that supply should be curtailed. If the shortage is in sales system gas supply, then the sales customers should be curtailed in order of priority given in approved curtailment procedures. If the supply shortage is in gas which the LDC merely transports, then the transportation customer or customers whose supply is diminished should be curtailed.

Should the need for curtailment arise because of facility constraints, firm customers--be they sales or transportation--should have priority over interruptible customers. Within this

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115 T.E., page 179.

116 T.E., page 149.

117 T.E., pages 44-46.

division, priority should be assigned as in the company's approved curtailment procedures.

A customer has the option to choose among various service offerings and should receive the priority of service for which he is willing to pay the associated charges. The Commission is of the opinion that the distinction in curtailment priorities should be consistent with the risk one incurs in making purchasing decisions. But in all cases, human needs must take priority.

Tariffs

The fact that transportation service can replace sales service, thereby resulting in increased gas costs for remaining sales customers, points out the need for proper assignment of costs in establishing what services are made available and what their rates will be. The Commission has been moving gradually toward unbundling of services. The rates for transportation service on the five Class A LDCs are generally set at the gross margin. Therefore, the LDC has an opportunity to obtain a contribution to fixed costs. The Commission has allowed the transportation rate to be flexed up or down to compete with alternate fuels.

The current transportation tariffs of Columbia and ULH&P limit availability by requiring an alternate fuel capability except by special contract. The tariffs of Delta, LG&E, and WKG do not contain this requirement. The object of the Commission is to encourage use of the LDCs' system by maintaining nondiscriminatory open transportation tariffs. In addition, LDCs may make available transportation tariffs to compete with alternate fuels, subject to the Commission's approval, on a case-by-case basis. End-users who can arrange for its own supply of lower cost natural gas should be allowed access to the existing distribution network. This enhances competition for the acquisition of natural gas and in accord with KRS 278.507, may facilitate greater use of natural gas produced in Kentucky.

The Commission finds that LDCs should offer transportation on a nondiscriminatory basis. This means that transportation will be available to any end-user who can arrange for its own supply of natural gas unless the capacity simply does not exist. The Commission is aware that problems do occur with load balancing and accounting for receipt and delivery of natural gas in transportation. Thus, availability may be subject to a minimum volume requirement that will address these concerns.

The Commission finds that guidelines are appropriate to assist the natural gas utilities in revising transportation tariffs. The Commission will examine proposed transportation tariffs on a case-by-case basis. Utilities may be allowed to deviate from these guidelines based upon the circumstances of their service areas and customer needs. While the Commission is requiring all Class A LDCs and other intrastate transporters of natural gas to file a nondiscriminatory transportation tariff, its precise form and conditions may vary.

Transportation service should be provided without discrimination as to type and location of customer. All utilities should offer nondiscriminatory transportation, subject to available capacity, to any customer who requests it on a first come, first served basis. It shall be presumed that capacity is available on the utility's system. The burden of proof shall be on the utility to prove that capacity is not available.

For each transportation service a fixed rate shall be established which reflects an appropriate assignment of costs, considering both variable costs and fixed costs of the system.

Concerning the Commission's questions at the hearing on January 7, 1987, the Class A LDCs all supported the allowance of transportation tariffs designed to compete with alternate fuels. Such a flex tariff would include provisions to flex up or down from a fixed charge to compete with alternate fuels. The Commission is of the opinion that utilities may offer a flexible transportation rate to meet alternate fuel competition with the understanding that the utility must document and fully support the necessity to change the fixed rate in its next general rate case. In instances where the transportation rate is flexed from the fixed rate, the utility should notify the Commission. Further, the Commission will not allow flexing to subsidize competition by reducing transportation rates below cost.

At the discretion of the LDC a contract may be required for transportation service. The availability of transportation service may have a minimum volume requirement, subject to the Commission's approval, to help balance the utility's planning and contractual needs. The volume level should be determined by each utility and included in its tariff.

The location of entry points necessary for the transportation of gas through a utility's system should be determined by that transporting utility. The burden of proof shall be on the utility to demonstrate why a connection cannot be made at a specific location. Any construction necessary to accomplish each connection should be conducted or supervised by the transporting utility. All connections should be made at the expense of the one requesting the service. The transporting utility should own and maintain each connection made with it.

An LDC maintains no obligation to provide sales service to a transportation customer who fails to purchase standby sales service or some other means of reserving capacity. Transportation customers retain no entitlements to previous gas purchases beyond contract provisions.

SERVICE AREAS

Gas utility tariffs generally list the communities which the utility serves. The Commission finds it undesirable to designate a precise geographical area for each utility's service area. Although the Commission will not establish maps for natural gas service areas, any user of natural gas is assumed to be a customer of the distribution company serving other residential, commercial, and industrial customers in the vicinity. Likewise, any new customer would be presumed a customer of the LDC. This will allow the LDC first opportunity to serve customers and promote use of the LDC's facilities, yet the territories will remain open to provide access to competition.

Some of the parties suggested that this arrangement is unlawful delegation of the Commission's authority. However, the Commission is merely presuming that the LDC has the ability to serve any customers that may locate within a reasonable proximity of its existing facilities. The ultimate decision on whether the LDC or a competing utility will provide the service remains with the Commission. This practice does not differ from current practice, nor does it differ from what might occur if service areas were established. The Commission intends for the existing distribution facilities to be used optimally. If there is a void in the system which can be remedied most efficiently by the construction of facilities by someone other than the LDC, it should be allowed. However, this policy merely recognizes that the LDC generally has the facilities in place that can be used economically to meet normal growth and demand for gas within a given locale.

BYPASS

The Commission recognizes two types of potential bypass facing LDCs. First, bypass of the LDC for natural gas supply and, second, physical bypass of the transmission and distribution plant of the LDC. The Commission asked the question in this docket, "Do you support or oppose bypass of the LDC? Explain."

LDCs were unanimous in opposing bypass. Delta is opposed to bypass because of resultant higher rates to remaining customers.[118]

[118] Delta response to Commission's Order dated January 17, 1986, Question No. 13, page 6.

Columbia,[119] WKG,[120] and LG&E[121] also raised the issue of the adverse impact on remaining customers caused by virtually the same fixed cost being spread over smaller sales volume. According to LG&E, allowing bypass of the LDC's system would result in selective market raiding of large, high load factor customers.[122] LG&E pointed out that this is commonly referred to as "cream-skimming" and takes away customers that are important for load management.[123] Off-peak customers are important to the efficient use of transmission and distribution systems, but they are also the class of customers capable of leaving the system entirely by switching to alternate fuels.

In Columbia's opinion, when the LDC can effectively provide sales or transportation service at a cost to the end-user less than or equal to the end-user's value of service, as defined by alternate or replacement energy cost, bypass should not be permitted.[124] While Columbia's comment was made in opposition to

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119 Columbia response to Commission's Order dated January 17, 1986, Question No. 13, page 11.

120 WKG response to Commission's Order dated January 17, 1986, Question No. 13, page 14.

121 LG&E response to Commission's Order dated January 17, 1986, Question No. 13, page 5.

122 LG&E response to Commission's Order dated January 17, 1986, Question No. 13, page 5.

123 Ibid.

124 Columbia response to Commission's Order dated January 17, 1986, Question No. 13, page 11.

bypass, it would probably be acceptable to several parties that made comments supporting bypass.

The opinion of the proponents of bypass is well represented by the comments of Southwire. According to Southwire, the mere threat of competition can accomplish the same positive benefits as actual competition, and a full, fair, unobstructed opportunity to compete with the LDC will induce better LDC performance.[125] Southwire further stated its belief that if the LDC would use its purchasing power and proper rate design principles, the interest in bypass could be eliminated.[126] Stand Energy[127] and Xebec[128] also saw the opportunity for bypass as an incentive for LDCs. In the opinion of GTE, the option to bypass will force LDCs to become more efficient and is conceptually no different from an end-user's installation of alternate fuel capabilities.[129] KIUC also supported the ability to bypass but stated that the real possibility of bypass is greatly diminished by competitive gas transportation and sales rates of an LDC.[130]

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125 Southwire response to Commission's Order dated January 17, 1986, page 9.

126 *Ibid.*

127 Stand Energy response to Commission's Order dated January 17, 1986, Question No. 13.

128 Xebec response to Commission's Order dated January 17, 1986, Question No. 13, page 2.

129 GTE response to Commission's Order dated January 17, 1986, Question No. 13, page 7.

130 KIUC response to Commission's Order dated January 17, 1986, Question No. 13, page 6.

Moreover, KIUC stated that bypass does not always mean total abandonment of the LDC.[131] This point was also made by Southern who saw bypassers as remaining connected to the LDC and varying the mix of LDC gas, bypass gas, and transportation to achieve an optimum balance between price and reliability considerations.[132]

TCO and Columbia Gulf do not favor bypass of their wholesale customers.[133] They prefer selling or transporting gas to wholesale customers for sale to end-users, except in certain instances, where a customer might switch to alternate fuels or the load is one which the wholesale customer could not accommodate.[134] The comments of Tennessee express a similar desire to allow the LDC to be competitive but, likewise, Tennessee would consider bypass sales if the load were to be lost to an alternative energy source.[135]

The Commission's authorization of transportation programs has, in effect, permitted supply bypass of the LDC. This type of bypass allows a customer flexibility to determine the level of supply reliability and distribution company service it wants. In their comments, all of the parties acknowledged certain supply and

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131 Ibid.

132 Southern response to Commission's Order dated January 17, 1986, Question No. 13, page 16.

133 TCO and Columbia Gulf Joint response to Commission's Order dated January 17, 1986, Question No. 13, page 6.

134 Ibid.

135 Tennessee and Midwestern Joint response to Commission's Order dated January 17, 1986, Question No. 13, page 12.

reliability risks associated with bypass. Recognizing these factors, each customer must assess the risk and management variables when it enters the market for its own source of natural gas supply. The Commission finds this flexibility to be in the public interest as a means of reducing the overall cost of natural gas supplies to all consumers. Thus the LDC, as well as end-users, will be striving to obtain the most reasonably priced natural gas.

The matter of physical bypass of an LDC's system requires additional consideration. Recent changes in federal regulation have created numerous opportunities in arranging natural gas supply. This Commission is responsible for ensuring that gas service in Kentucky is offered at fair, just, and reasonable rates and in the public interest. As Columbia points out, the Commission must assert certificate authority over this situation to balance the interest of all affected customers.[136] LG&E equates unrestricted bypass with allowing a second utility to run mains up and down the street hooking up any customer it can.[137] The Commission is aware of an additional consideration, especially important to local governments: bypassers may escape the taxes that are collected by LDCs for local governments and school districts.

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136 Columbia response to Commission's Order dated January 17, 1986, Question No. 11, page 7.

137 LG&E response to Commission's Order dated January 17, 1986, Question No. 13, page 6.

In its Draft Order the Commission proposed that a certificate of convenience and necessity should be required for any entity proposing physical bypass of an LDC. Comments submitted by GTE, in response to the Draft Order, were indicative of most industrials' comments in stating that a physical bypass facility not available to or for the public is not a utility and does not need a certificate.[138] Further, GTE stated that it is beyond the Commission's jurisdiction to require such a certificate.[139] Southwire agreed saying only a utility can be required to apply for a certificate.[140] KIUC thought it unwise to attempt to regulate the construction of bypass facilities which it sees as a pro-competitive threat.[141] KIUC,[142] along with TCO and Columbia Gulf,[143] questioned the Commission's authority to regulate construction of interstate pipelines' facilities.

The AG would require companies physically bypassing the LDC to pay an exit fee to compensate the LDC for the costs associated

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138 GTE response to Commission's Order dated September 30, 1986, page 3.

139 *Ibid.*

140 Southwire response to Commission's Order dated September 30, 1986, page 12.

141 KIUC response to Commission's Order dated September 30, 1986, page 5.

142 *Ibid.*

143 TCO and Columbia Gulf joint response to the Commission's Order dated September 30, 1986, page 4.

with discontinuing service and abandoning or maintaining the investment needed to serve the customer.[144]

The Commission requested testimony regarding the following question in the January 7, 1987, hearing, "In what instance should a certificate for physical bypass not be required?" Delta,[145] LG&E,[146] WKG,[147] Columbia,[148] and ULH&P[149] all stated a certificate and PSC approval should be required in every situation.

Briefs submitted following the hearing were divided along the lines previously stated for each party. Generally, the LDCs would have the Commission require a certificate for any type of physical bypass. The AG supports the Commission's jurisdiction over bypass, but considers the proposed policy for regulation to be too restrictive.[150]

GTE, Southwire, and NSA, in a combined brief, supported shifting the burden of proof to the party opposing a bypass

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144 AG response to Commission's Order dated September 30, 1986, page 6.

145 T.E., page 43.

146 T.E., page 90.

147 T.E., page 129.

148 T.E., page 148.

149 T.E., page 170.

150 AG Brief in response to Public Hearing January 7, 1987, page 6.

situation; and, absent a showing to the contrary, the public convenience and necessity would be assumed to exist.[151]

The remaining briefs essentially agreed with Alcan in taking the position that an entity establishing physical bypass of an LDC at its own expense and for its own private use does not fit the statutory definition of a utility and therefore cannot be required to obtain a certificate.[152] The Commission has discussed earlier in this Order, under the heading PSC Jurisdiction, the definitions of "utility" and "public" and how they are applied.

The Commission finds that a utility proposing physical bypass of an LDC in order to accommodate the use of natural gas by an end-user should be required to make application to this Commission requesting a certificate of convenience and necessity to bypass the LDC. No construction of any sort should be permitted before the certificate proceedings are completed. The Commission finds this necessary to prevent duplication of facilities and to protect the public interest.

If a bypass is proposed because an LDC does not have transportation capacity available, or for any other reason is unwilling to serve, the burden of proof should be on the LDC to show the reasons why it is unable or unwilling to serve. The Commission finds it appropriate to place the burden of proof on

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[151] GTE, Southwire, and NSA Brief in response to Public Hearing January 7, 1987, page 11.

[152] Alcan Brief in response to Public Hearing January 7, 1987, page 3.

the LDC for the same reasons the burden of proof in transportation capacity was placed on the LDC on page 49 of this Order.

Following a determination that any proposed construction does not represent a duplication of facilities, and that the proposed bypass is in the public interest, a certificate of convenience and necessity may be issued under the terms of KRS 278.020. The Commission is of the opinion that its policy will encourage LDCs to participate in competition at the wholesale level while promoting use of the existing retail distribution system, yet will not prohibit greater access to natural gas.

Finally, the Commission is of the opinion that an end-user who builds, owns, operates and controls a pipeline for its sole use, and for the sole purpose of providing itself with natural gas for its own use is not subject to regulation. In this instance, there is no public sale. However, this is not an open invitation to bypass the existing utility network.

An end-user may construct its own facilities to connect to a utility supplier. However, that utility supplier, whether a producer, transporter or distributor, must apply to the Commission for a certificate of convenience and necessity prior to the connection of its facilities with those of the end-user. In this case, there is a sale to the public. To allow end-users to build facilities that connect with existing utility facilities without some oversight could result in uneconomic use of the production and distribution system. Furthermore, because one of the goals of this proceeding is to treat all participants in the industry fairly, it would be unjust to require regulated companies to certificate their construction, but allow end-users an unfettered opportunity to connect to those facilities without some proof of need and without allowing the existing utility an opportunity to provide the service.

The Commission asked other questions in this docket concerning a utility's obligation to bypassers and the Commission's obligation to bypassers. The record indicates that most parties agree that a utility's obligation to serve should be modified. Southern summed this up by stating that an LDC should be released from its obligation to serve commensurate with the nature and extent of bypass.[153] KIUC stated that a utility should be obligated to serve where it has the capacity to serve.[154] In general the comments seemed to imply that reservation charges or standby fees are in order for bypassers that desire the comfort of having some level of reserved service with an LDC. Again, to quote KIUC,

> (c)learly customers who have left the system cannot expect a bypassed LDC to jeopardize service to existing customers in order to serve them in the event that their better deal goes sour, unless the LDC receives some fee commensurate with the cost of reserving capacity and gas for that customer on the distribution system.[155]

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153 Southern response to Commission's Order dated January 17, 1986, Question No. 12, page 12.

154 KIUC response to Commission's Order dated January 17, 1986, Question No. 12, page 5.

155 KIUC response to Commission's Order dated January 17, 1986, Question No. 13, page 7.

In response to the question "Should the Commission have a regulatory responsibility to bypassers?", WKG[156] said "no", as did LG&E.[157] In Columbia's opinion there should be significant regulation of bypassers to assure that the needs of the public are fully served.[158] Delta agreed that the Commission's obligation extends to the same factors of fair rates, reliability, safety, nondiscriminatory service, and proper operations as for other utility customers.[159] GTE agreed that the Commission has an obligation to assure fair and equitable treatment and that any customer bypassing the LDC should be considered as a potential new customer for the LDC.[160] Xebec shared in this opinion that the Commission has an obligation to ensure that if a bypasser requests the LDC to reestablish gas service, such service is indeed reestablished if capacity and/or supply is available.[161]

The Commission recognizes that in order for an LDC to maintain its ability to act as a merchant of natural gas and meet its obligation to serve, it must make certain supply commitments.

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156 WKG response to Commission's Order dated January 17, 1986, Question No. 13, page 17.

157 LG&E response to Commission's Order dated January 17, 1986, Question No. 13, page 7.

158 Columbia response to Commission's Order dated January 17, 1986, Question No. 13, page 13.

159 Delta response to Commission's Order dated January 17, 1986, Question No. 13, page 8.

160 GTE response to Commission's Order dated January 17, 1986, page 10.

161 Xebec response to Commission's Order dated January 17, 1986, Question No. 13, page 3.

These commitments are eliminated to the extent that a customer elects to bypass the LDC. The Commission finds it fair and reasonable for an LDC to offer a reservation or standy-by fee as a part of its tariff schedule to reserve the level of supply or capacity commitment desired by bypassers.

In its Draft Order the Commission proposed to require a reasonable re-entry fee from bypassers that make no reservations on the system and then request supply and/or transportation from the LDC. The Commission later asked for testimony on re-entry fees vs. exit fees for bypassers.

LG&E expressed concern that exit fees were difficult to enforce without a contractual agreement for a period of service.[162] WKG did not see exit fees as realistic for interruptible customers[163] and GTE was concerned that they could be punitive.[164]

GTE opposed re-entry fees because it saw the fees as limiting the ability to return to the system.[165] Columbia recognized this same concern but resolved it by proposing that the fees be optional.[166] According to LG&E, re-entry fees make the most sense

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[162] T.E., page 89.

[163] T.E., page 129.

[164] T.E., page 179.

[165] T.E., page 177.

[166] T.E., page 147.

where the additional cost to bring a customer back on the system can be demonstrated.[167]

The Commission finds that it is reasonable in cases where a bypasser chooses not to reserve a place with the LDC, that the LDC may require a reasonable re-entry fee when the bypasser comes back to request supply and/or transportation from the LDC. The re-entry fee should be determined by tariff and considered by the Commission on a case-by-case basis. The size of the bypasser and LDC and the LDC's pipeline commitments should be among the factors considered in determining a reasonable re-entry fee.

ORDERS

IT IS THEREFORE ORDERED that:

1. Within 30 days of the date of this Order, all utilities that have not previously done so shall file with this Commission their current rates, maps of their facilities, and a description of their business activities.

2. The Commission shall reserve the right of open access to the records of any subsidiaries acting as brokers or dealers of natural gas. The Commission shall review the operations of the regulated company to ensure that no cross-subsidy or unfair competition exists.

3. The Commission shall conduct annual purchasing reviews of the Class A LDCs. Each Class A LDC shall file the details of its demand forecast and acquisition planning procedures for the

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[167] T.E., pages 89 and 90.

1986-87 and 1987-88 heating seasons with this Commission by August 30, 1987.

4. No later than its next rate case, each Class A LDC shall include in its tariff separate rates for the sale and transportation of natural gas and a separate rate for standby service.

5. Each Class A LDC shall complete a cost-of-service study as called for herein to be submitted in its next rate case. This study shall be used as the starting point for rate design. No change in actual rates or rate design will be considered outside a rate case proceeding.

6. Each LDC shall notify the Commission's staff and parties to the company's last rate case early in the development of its cost-of-service study. The Commission shall then convene an informal conference of its staff, the LDC, and interested parties to discuss proposed cost-of-service methodologies and applications.

7. Each utility operating within the Commonwealth of Kentucky shall offer transportation of natural gas on a nondiscriminatory basis, first come, first served. There shall be a rebuttable presumption that capacity does exist on an LDC's system for natural gas transportation. The burden of proof shall rest on the LDC to show that it cannot transport natural gas as requested. Priority shall be given to firm sales and firm transportation over interruptible sales and interruptible transportation. Should the need for curtailment arise, the curtailment priority shall be determined by the cause of curtailment. Class A LDCs and transporters shall maintain such tariffs on file at the Commission.

Any Class A LDC not in compliance shall amend its current transportation tariffs to the extent necessary within 30 days of the date of this Order. All other utilities shall prepare and submit such tariffs to the Commission as needed.

8. A fixed rate shall be stated for each type of transportation service. In addition, a flexible transportation tariff may be offered to compete with alternate fuels. A minimum volume requirement may be established for transportation service subject to Commission approval.

9. Any user of natural gas is presumed to be a customer of the distribution company serving other residential, commercial, and industrial end-users in the area.

10. Any utility proposing physical bypass of an LDC's system shall obtain a certificate of convenience and necessity from this Commission. Said utility shall make such filing according to the Commission's Rules of Procedure for obtaining a certificate of public convenience and necessity for new construction or extension pursuant to the requirements of 807 KAR 5:001.

11. To the extent that an end-user chooses to bypass its LDC, the LDC shall be relieved of its obligation to that customer. An LDC may require a reasonable re-entry fee when the end-user requesting service has previously bypassed its system. The fee shall be subject to the Commission's approval on a case-by-case basis.

Done at Frankfort, Kentucky, this 29th day of May, 1987.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director